

auditor choice to only the largest auditing firms for many large public companies. The Committee heard from witnesses who also described barriers to the growth of smaller auditing firms, including the behavior of underwriters and other capital market participants.<sup>119</sup>

In analyzing these data on concentration and limited auditor choice in the large public company audit market, the Committee focused on the potential negative impact of concentration on audit quality. Some have suggested the lack of competition may not provide sufficient incentive for the dominant auditing firms to deliver high quality and innovative audit services.<sup>120</sup>

Notwithstanding the increasing number of public company financial restatements,<sup>121</sup> the Committee heard from several witnesses that audit quality had improved.<sup>122</sup> For example, the GAO observed that market participants and public company officials had noted improvement in recent years in audit quality, including auditing firm staff's technical expertise, responsiveness to client needs, and ability to identify material financial reporting matters.<sup>123</sup> Much of the improvement was credited to the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which enhanced auditor independence, replaced the self-regulation of the auditing profession with the PCAOB, mandated evaluation and disclosure of the effectiveness of internal controls over financial reporting,<sup>124</sup> and

strengthened audit committee membership, independence, and responsibilities.

Although industry concentration can lead to increased prices, the Committee notes that the GAO concluded that higher audit market concentration has not been associated with higher fees. Public companies, auditing firms, and other market participants believe the considerable increase in audit fees in recent years is due not to market power of a concentrated industry, but to the increased requirements under Sarbanes-Oxley, the complexity of accounting and financial reporting standards, the need to hire and retain qualified audit staff, and the independence requirements (which have led to the possible re-pricing of audits to their unbundled market price).<sup>125</sup> The Committee also considered the impact of the possible loss of one of the four largest accounting firms in light of the high degree of concentration of public company auditing, and especially large public company auditing, in those firms. The GAO noted the possibility of this loss due to issues arising out of firm conduct, such as civil litigation, federal or state regulatory action or criminal prosecution, or economic events, such as a merger.<sup>126</sup> The GAO posited potential negative effects of such a loss, including the following: Further limitations on large public company auditor choice, costs associated with changing auditors, and companies' inability to obtain timely financial statement audits.<sup>127</sup> However, the GAO did not recommend insulating auditing firms directly from either the legal or market consequences of their actions.

With the above considerations in mind, the Committee recommends that regulators, the auditing profession, and other bodies, as applicable, effectuate the following:

Recommendation 1. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the Committee recognizes that Recommendation 2 will be a higher priority in the near term.

The GAO concluded that concentration in the large public company audit market will not be reduced in the near term by smaller auditing firms. The Committee considered testimony regarding the reasons that smaller auditing firms are unable or unwilling to enter the large public company audit market. Challenges facing these firms' entry into this market typically include the following: lack of staffing and geographic limitations on both the physical span of their practices and experience and expertise with global auditing complexities; inability to create global networks necessary to serve global clients, due to lack of auditing firms abroad to act as potential partners; the need for greater

technical capability and industry specialization; lack of name recognition and reputation; and limited access to capital.<sup>128</sup> In addition, expanding into the large public company audit market may be unattractive for some smaller auditing firms for a variety of reasons,<sup>129</sup> including increased exposure to litigation, the possibility that their business model is not scaleable, and the fact that for some smaller firms other aspects of their business (such as private company auditing and other work) has greater potential for expansion.

To address these issues, the Committee recommends that policy makers press for the reduction of barriers, to the extent consistent with audit quality and other public interest factors, to the growth of smaller auditing firms. For smaller firms, this includes encouraging and promoting development of technical resources in such areas as international financial reporting standards and fair value accounting, and development of specialized or "niche" practices or industry "verticals" where they are in the best interests of investors and can lead to more effective competition. Pressure also should be applied against non-justifiable resistance to using smaller firms on the part of a variety of market actors.

The Committee believes that the following specific and incremental actions would assist in the growth of the smaller firms and their entry into the large public company audit market:

(a) Require disclosure by public companies in their annual reports and proxy statements of any provisions in agreements with third parties that limit auditor choice.

The Committee considered testimony and commentary that certain market participants, such as underwriters, banks, and lenders, may influence and effectively limit public company auditor selection decisions.<sup>130</sup> For instance, certain contractual arrangements limit public companies' auditor choice.<sup>131</sup>

<sup>128</sup> 2008 GAO Report 37. See also Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf> (describing as barriers for smaller auditing firms liability risks, overly complex independence rules, and an array of factors that audit committees may review in choosing an auditor that best matches the company); Record of Proceedings (Feb. 4, 2008) (Written Submission of Neal D. Spencer, Managing Partner, BKD, LLP, 1), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Spencer020408.pdf> (noting that barriers include resources, institutional bias, insurability, and liability).

<sup>129</sup> 2008 GAO Report 38.

<sup>130</sup> See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 3), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (noting that transparency regarding "restrictive contracts with underwriters" could improve auditor choice). See also 2008 GAO Report 47.

<sup>131</sup> See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Lewis H. Ferguson, III, Partner, Gibson Dunn & Crutcher, 2), available at

specialization or expertise (67%)); Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>; Record of Proceedings (Feb. 4, 2008) (Written Submission of Neal D. Spencer, Managing Partner, BKD, LLP, 1-4), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Spencer020408.pdf>.

<sup>119</sup> Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs, 219-220), available at <http://www.treas.gov/offices/domestic-finance/acap/Koenig020408.pdf> (describing underwriters' views of auditing firms other than the largest four auditing firms).

<sup>120</sup> 2008 GAO Report 31-32.

<sup>121</sup> See, e.g., Susan Scholz, *The Changing Nature and Consequences of Public Company Financial Restatements 1997-2006* (April 2008).

<sup>122</sup> 2008 GAO Report 5; Public Company Accounting Oversight Board, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms*, PCAOB Rel. No. 2007-010 (Oct. 22, 2007).

<sup>123</sup> Record of Proceedings (Dec. 3, 2007) (Questions for the Record of Ms. Jeanette M. Franzel, Director, Financial Management and Assurance Team, U.S. Government Accountability Office, 2 (Jan. 30, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf> (observing that the market believes the "bar had been raised" on audit quality). See also Center for Audit Quality, *Report on the Survey of Audit Committee Members* (March 2008) (concluding that: 17% of surveyed audit committee members view audit quality as good, 53% as very good, 25% as excellent, while 82% say overall quality has improved somewhat/significantly over the past several years).

<sup>124</sup> 2008 GAO Report 32.

<sup>125</sup> 2008 GAO Report 27-29. On the re-pricing of audits, see also James D. Cox, *The Oligopolistic Gatekeeper: The U.S. Accounting Profession*, in *After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the U.S.*, Chapter 9, Oxford, forthcoming, available at <http://ssrn.com/abstract=926360>.

<sup>126</sup> 2008 GAO Report 34-35.

<sup>127</sup> 2008 GAO Report 35-36.